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Attachment 1

**February 18, 2003**

**AGENDA ITEM 6a**

**TO : MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Joint AIM/Global Equity Hedge Fund Program
- II. PROGRAM:** Joint AIM/Global Equity Hedge Fund Program
- III. RECOMMENDATION:** Staff is recommending the Investment Committee approve the following program enhancements:
- 1) Change the program name from the "Joint AIM/Global Equity Hedge Fund Program" to the "Joint AIM/Global Equity Absolute Return Strategies Program" (ARS)
  - 2) Allow Staff to select multiple strategic advisors through a focused competitive solicitation process to create a Spring-Fed Pool of strategic advisors to assist CalPERS in managing the ARS Program. As the current strategic advisor to the ARS Program, Blackstone Alternative Asset Management (Blackstone) will be included in the Spring-Fed Pool of Advisors.
  - 3) Retention of State Street International Fund Services (IFS) portfolio management system to provide increased transparency and risk analysis for the ARS Program, using the Best Business Practices exemption.

A recommendation for additional ARS Program allocation will be made to the Investment Committee at the June 2003 meeting as part of the FY 2003/2004 Annual Planning process.

#### **IV. BACKGROUND AND ANALYSIS:**

At the October 16, 2000 Investment Committee meeting an informational item was presented to the Investment Committee regarding a Joint AIM/Global Equity program for hedge funds. Attachment 1 is a copy of this agenda item.

At the November 13, 2000 Investment Committee meeting, the Committee approved: 1) The establishment of the "Joint AIM/Global Equity Hedge Fund Program," 2) An initial allocation of up to \$1 billion, and 3) A focused competitive solicitation search process for a strategic partner to assist CalPERS in managing the "Joint AIM/Global Equity Hedge Fund Program." Attachment 2 is a copy of the November 13, 2000 agenda item.

At the May 14, 2001 Investment Committee meeting, the Investment Committee approved the selection of Blackstone as the Strategic Advisor for the Program. Attachment 3 is a copy of the May 14, 2001 agenda item.

The Joint AIM/Global Equity Hedge Fund Program (Program) is the evolution of CalPERS' efforts to enter into the hedge fund market. The AIM program received approval to invest in hedge funds and hybrid investments in November 1996 while Global Equity received approval in August 1999. Together the AIM unit and the Global Equity unit have combined efforts and resources to present a unified and comprehensive approach to the hedge fund market. The objective of AIM and Global Equity is to make CalPERS the investor of choice within the hedge fund market.

##### **1. Performance Update**

The Program has performed well. From its initial investment on April 1, 2002 through December 31, 2002, the Program posted a 2.4% return, gross of fees as compared to the benchmark (50% Wilshire 2500 and 50% 1 Year Treasuries) which returned -7.7%. This represents an outperformance of 10.1% for the Program. On a net of fees basis, the Program returned -0.9%, outperforming the benchmark by 6.8%. Compared to the internal domestic passive portfolio, from which the assets were allocated to fund the Program, the outperformance was 20.5% (-0.9% vs. -21.4%) on a net of fee basis. It is important to note that a significant amount of the costs reflected in the performance are from the legal costs associated with establishing the Program and the fees paid to Blackstone for providing a bundled advisory service. Attachment 4 is a list of the Program's investments, the assets allocated to each manager and the inception date of each investment.

##### **2. Enhanced Transparency**

Staff recommends the custodial services of State Street Bank be expanded to include the State Street International Fund Services (IFS) system, subject to successful negotiation of terms using the Best Business Practices exemption. IFS will provide improved transparency, fund accounting, compliance and risk monitoring and reporting for the ARS program.

### **3. Role of Blackstone Alternative Asset Management**

CalPERS has had a successful strategic relationship with Blackstone since October of 2001. Blackstone has done a solid job in meeting its commitment to CalPERS in working with staff in developing the overall plan design, conducting manager due diligence, performance monitoring and providing staff with guidance. Blackstone's contract expires on June 30<sup>th</sup> 2003. Staff is recommending that Blackstone be included in the Spring-Fed Pool, subject to successful negotiation of terms and conditions.

### **4. Addition of Multiple Strategic Partners**

Staff recommends the Investment Committee allow Staff to select multiple strategic advisors through a focused competitive solicitation search. This will allow CalPERS to build a Spring-Fed Pool of strategic advisors, similar in function and design to the AIM Program's Pool of Advisors. As the hedge fund effort at CalPERS has evolved and matured, so too have our requirements. First, multiple partners will expand the universe from which to select managers. Second, additional partners will provide another level of due diligence on the managers being considered and monitored. Third, additional providers will increase our ability to secure capacity with a broader array of managers as well as allow CalPERS to negotiate better fee arrangements and terms with both the partners and managers. Fourth, the additional partners will allow staff to obtain knowledge from a variety of sources. Lastly, this will improve CalPERS flexibility in designing the Program. Going forward, the ability to leverage the knowledge and skills of multiple partners will increase the probability of achieving the long-term goal of developing a successful Program that exceeds its performance objectives. Staff will work with the Legal Office on structuring the program so that all advisor costs will continue to be captured by the program.

### **5. Program Investment Objective and Name Change**

The Program has been constructed to invest in established hedge funds that are primarily equity based and limit the amount of leverage. This conservative approach will continue.

Staff is recommending changing the name of the Program to "Absolute Return Strategies" in order to reflect the full range of hedge fund strategies available in the marketplace. Furthermore, this new name more appropriately characterizes the Program's return objective in contrast to the relative return strategies within Global Equity.

### **6. Risk Management**

Staff will perform risk analysis on the program from three separate independent sources. First, staff will perform its own internal risk analysis. Second, staff will be provided risk analysis reports from IFS. Third, staff will require at least one of the

strategic partners to engage in overall risk analysis and optimize plan design to maximize return and minimize risk.

## **7. Reports**

On a quarterly basis, staff will continue to report to the Investment Committee the performance, the list of managers in the Program and the amounts managed by each.

## **V. STRATEGIC PLAN:**

Goal IV: Assure that sufficient funds are available, first to pay benefits and, second, to minimize and stabilize employer contributions.

## **VI. RESULTS/COSTS:**

The Hedge Fund Program's allocation of \$1 billion comes from the Global Equity allocation. Approximately half of the initial investment still remains to be invested. Staff anticipates addressing the allocation to the Program at the June Investment Committee meeting as part of the strategic plan for Global Equity.

Staff is making the above recommendations in order to expand the global equity opportunity set, enhance returns, reduce overall plan risk and position CalPERS as the investor of choice in the hedge fund marketplace.

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